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Commentary

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The Urban Papers

Municipal Finance in a New Fiscal Environment

Harry Kitchen

In this issue...

A proposal to reform property taxes to better match benefits and costs, set user fees more efficiently, and allow hard-pressed municipalities access to new tax sources.

The Study in Brief

Financing Canadian municipalities is an increasing concern in today's environment of downloading and reshuffling of provincial-municipal responsibilities.

Not surprisingly, politicians are joining tax analysts in wondering whether taxes can be levied more wisely. Should changes be made to the property tax? Are there structural problems with existing user fees? Can expanding them be justified? Should municipalities have access to additional tax sources?

The benefits model of taxation is ideal for answering these questions because it concentrates on decisionmaking and funding responsibilities, not production and delivery. The basic idea is simple: those who benefit from services should pay for them, satisfying the traditional taxation tests of efficiency, equity, accountability, and ease of administration. Thus, a municipality's taxes should fund the range of local services enjoyed by its own residents, but *not* redistribution of income or benefits that spill over onto neighboring communities, commuters, or visitors.

The property tax is rightly the lynchpin of municipal taxation. In most jurisdictions, however, it needs reforming to better correlate benefits with their costs. Specifically, municipalities should use variable tax rates (or special assessments) to capture cost differences in providing services across properties. And they should remove the current discrimination against nonresidential properties because it results in the overtaxation of businesses *vis-à-vis* homes and small multi-unit buildings.

Municipalities also raise revenue from fees charged for services ranging from water supply and sewage treatment to public transit. If correctly set — where the fee reflects the extra cost of providing the last unit — fees have the advantages of rationing services to those willing to pay for them and discouraging the authorities from overinvestment in those facilities and taxpayers from overuse. Some difficulties in achieving this ideal might be offset by increasing charges — for example, asking public transit users to pay the full marginal cost could be balanced by higher fees for automobile licenses and municipal parking.

Finally, because municipalities fund a range of services, some of which generate spillovers or are of an income redistributional nature, the provinces should give them access to additional revenue sources — in particular, sales and fuel taxes.

The Author of This Issue

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Until recently, Canadians have given municipal finance issues relatively little attention. From the 1950s through the early 1990s, one provincial government or another occasionally appointed a commission, committee, or task force to recommend changes, generally concentrating on the reform of property taxation and, less frequently, on disentangling or realigning provincial-municipal service responsibilities. All too often, however, these recommendations were ignored, and virtually nothing of any substance was implemented. Over the past decade, this inattention has changed. Provinces, some more than others, have altered the fiscal environment in which municipalities now operate: through, for example, reducing provincial grants, realigning provincial-municipal funding responsibilities, increasing the emphasis on amalgamating municipalities,[1] and establishing ongoing initiatives to reform property taxes (see Slack 1999).

This new fiscal environment has emerged at the same time as cities and regions have become increasingly important in the competitive global economy. Individuals' and businesses' location decisions are driven by a variety of factors, a major one being the quality and quantity of municipal services and the way they are financed (see Kitchen and Slack 1993). This goal has put increasing pressure on municipal governments and increased the importance of a number of questions. For example, for what specific expenditures should funding responsibilities be left with local governments? Is the property tax a good tax for local government, and should specific changes be made to its application? What are the problems with the pricing structure of existing user fees, and is there room for expanding their use? Does a case exist for giving Canadian municipalities access to additional tax sources? This *Commentary* addresses these major questions.

My conclusions, in brief, are that the new fiscal environment and the growing importance of cities in the global economy make it imperative that provincial and municipal governments pay more attention to efficiency and accountability arguments in designing and implementing local taxes. To this end, they should place greater emphasis on correctly designing user fees, especially those for water and sewers, public transit, and solid waste collection and disposal. As well, they should reverse the current practice of overtaxing the nonresidential sector, thereby permitting businesses to perform better in increasingly competitive international markets. Finally, municipalities should have access to local fuel taxes and local sales taxes, piggybacking both onto existing provincial taxes but with rates set locally.

To provide a basis for these recommendations, I have organized this *Commentary* in the following way. The next section summarizes municipal revenue trends over the 1988–98 period. Following this is a discussion of the principles for funding municipal services and the assignment of tax powers. The next — and longest — section covers specific issues; the role for and reform of property taxes constitute a separate subsection, as do the role for and reform of user fees and potential access to additional tax sources. The concluding section summarizes the desired reforms and comments on the political likelihood of their implementation.

The author wishes to thank Richard Bird, Jack Mintz, Finn Poschmann, Bill Robson, Enid Slack, and Almos Tassonyi for helpful and constructive comments on earlier drafts.

1 I do not discuss municipal amalgamation here; it is the focus of a forthcoming *C.D. Howe Institute Commentary* by Robert Bish.

Municipal Revenue Trends

The 1990s' trends in the provincial downloading of increased expenditure responsibilities, the decline of provincial grants and an offsetting increased reliance on own-source revenues (revenues over which a municipality controls the yield) have changed the fiscal environment in which municipalities must operate.[2] In 1998, senior government grants in all provinces combined accounted for slightly more than 15 percent of all municipal revenues (Table 1), down from almost 23 percent in 1988 (Table 2).[3] Offsetting this decrease in the relative importance of provincial grants was a corresponding increase in the relative importance of property taxes for funding municipal services: from slightly less than 49 percent of municipal revenues in 1988 to almost 57 percent by 1998. User fees, the other major component of own-source revenue, remained unchanged in relative importance over this period.

While recent trends have left municipalities with more funding responsibilities, they have gained very little freedom to behave as they wish. They remain creatures of the province.

While this trend has left municipalities with more funding responsibilities, they have gained very little freedom to behave as they wish. Municipalities remain creatures of the province and are frequently required to use locally generated revenues to meet provincially determined standards and goals. The most obvious example is in Ontario, where Queen's Park implemented a number of initiatives in 1998 that dramatically changed the provincial-municipal fiscal environment. Specifically, the province increased its role in school funding by imposing a province-wide education (property) tax. To meet its objective of implementing changes that were revenue neutral, it transferred to municipalities increased funding responsibility for a variety of services (social housing, 50 percent of land ambulances, and, prior to 1998, provincial highways) but gave them very little (if any) say in service standards.

Other provincial governments have also initiated changes in their provincial-municipal fiscal environment. For example, in 1990, Quebec transferred to municipalities the financing of public transit, road maintenance, and other services. Local restructuring in Alberta in 1994 led to full provincial funding of elementary and secondary education and a 50 percent reduction in the number of school boards. In Nova Scotia, a recent provincial-municipal service exchange has led to the province's committing itself to provide full funding for social services by 2003 and municipalities' assuming fiscal responsibility for roads and police.

The provincial-municipal scene in Ontario has differed from that in the other provinces for some time (Kitchen 1984), and this relationship has changed even more in the past decade, as Tables 1, 2, and 3 illustrate. Ontario has had the country's highest per capita municipal spending, and between 1988 and 1998 it increased by almost 40 percent in current dollars and by almost 19 percent in constant 1998 dollars; for the rest of Canada, the corresponding change was an increase in current dollars of less than 10 percent and a decrease in constant dollars of almost 15 percent.

Table 4 provides information on the distribution of the various revenue sources used by municipalities in Ontario and the rest of Canada for 1988 and 1998. Notice the relative importance of property taxes. As a percentage of all municipal revenue, their share in Ontario increased dramatically over the period, rising from almost 42 percent

2 For further discussion of this change, see Kitchen (2000).

3 I chose the 1988–98 period for comparative purposes because 1988 is the first year for which municipal data are available on a consistent and uniform basis and 1998 is the last year.

Table 1: ***Distribution of Municipal Government Revenue, 1998***

Revenue Source	Nfld.	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta.	BC	Yukon	NWT	Canada
						(percentage of whole)							
Property taxes	54.1	60.2	70.4	53.2	68.5	56.4	43.3	53.6	42.6	52.4	46.9	14.4	56.7
Other taxes[a]	1.7	0.5	0.2	0.4	0.3	1.1	1.8	4.5	1.3	3.0	1.8	0.5	1.2
User fees	15.6	28.4	15.9	22.1	15.4	19.5	20.8	24.1	30.4	26.7	19.7	29.2	20.7
Investment income	1.7	2.3	2.8	0.7	1.9	3.7	5.8	7.5	13.3	8.2	4.7	1.3	4.9
Other own-source revenue[b]	0.6	1.6	0.4	0.6	2.4	0.6	0.8	1.0	1.3	0.5	0.7	0.3	1.1
Total own-source revenue	73.7	92.9	89.7	77.0	88.5	81.4	72.5	90.8	89.0	90.8	73.8	45.7	84.6
Unconditional grants	8.5	3.2	2.6	13.7	1.3	3.6	6.3	4.6	1.4	1.5	9.4	6.7	2.9
Conditional grants	17.8	3.9	7.8	9.3	10.1	15.0	21.2	4.6	9.6	7.7	16.9	47.6	12.4
Federal	4.0	1.6	0.5	2.2	0.2	0.6	1.1	0.5	0.8	1.0	0.0	0.9	0.7
Provincial	13.8	2.3	7.3	7.1	9.9	14.4	20.1	4.1	8.8	6.7	16.9	46.8	11.8
Total grants	26.3	7.1	10.3	23.0	11.5	18.6	27.5	9.2	11.0	9.2	26.2	54.3	15.4
Total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a] Other taxes include licenses, permits, and miscellaneous taxes such as the extra 2 percent sales tax on hotel rooms in British Columbia, the surcharge on the Saskatchewan Power Corporation in Saskatchewan, and sales tax revenues from electricity and gas sales in Manitoba.

[b] Other revenues include amusement taxes, fines, and penalties.

Source: Author's calculations from 1998 estimates in Statistics Canada's Financial Management System, 1999, mimeographed.

Table 2: ***Distribution of Municipal Government Revenue, 1988***

Revenue Source	Nfld.	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta.	BC	Yukon	NWT	Canada
						(percentage of whole)							
Property taxes	41.9	50.0	58.0	41.7	68.8	41.7	44.5	48.1	36.3	48.0	31.7	16.6	48.6
Other taxes[a]	1.9	0.5	0.6	0.5	1.0	1.3	2.2	3.9	1.0	2.5	1.4	0.8	1.4
User fees	12.6	30.7	10.8	18.9	16.5	20.0	17.7	21.4	26.5	23.7	13.9	33.8	20.0
Investment income	1.9	3.7	3.7	1.2	3.0	5.1	8.3	6.7	12.8	10.1	4.1	2.1	6.0
Other own-source revenue[b]	0.4	1.2	0.8	0.6	2.0	0.7	1.0	1.4	1.4	0.5	0.6	0.2	1.1
Total own-source revenue	58.8	86.1	73.7	63.0	91.3	68.8	73.7	81.3	78.0	84.9	51.8	53.6	77.1
Unconditional grants	18.2	12.2	4.6	26.5	0.5	7.3	7.8	10.1	6.8	4.3	8.1	9.2	5.8
Conditional grants	23.0	1.7	21.6	10.5	8.3	23.8	18.5	8.6	15.2	10.8	40.2	37.2	17.1
Federal	3.1	0.2	0.4	1.6	0.2	0.9	1.2	0.3	0.5	1.1	1.0	0.3	0.7
Provincial	19.9	1.5	21.2	8.9	8.1	23.0	17.3	8.2	14.7	9.7	39.1	36.9	16.4
Total grants	41.2	13.9	26.3	37.0	8.7	31.2	26.3	18.7	22.0	15.1	48.2	46.4	22.9
Total revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Author's calculations from 1998 estimates in Statistics Canada's Financial Management System, 1999, mimeographed.

a Other taxes include licenses, permits, and miscellaneous taxes such as the extra 2 percent sales tax on hotel rooms in British Columbia, the surcharge on the Saskatchewan Power Corporation in Saskatchewan, and sales tax revenues from electricity and gas sales in Manitoba.

[b] Other revenues include amusement taxes, fines, and penalties.

Table 3: ***Municipal Expenditures and Their Distribution, 1988 and 1998***

Per Capita Expenditures	1988		1998	
	Ontario	Average for Rest of Canada	Ontario	Average for Rest of Canada
		(dollars)		
Current dollars	1,181	950	1,650	1,041
Constant 1998 dollars	1,389	1,216	1,650	1,041
Percentage growth, 1988–98				
Current dollars	—	—	39.7	9.6
Constant 1998 dollars	—	—	18.8	-14.4
		Distribution of spending (percentage of whole)		
General administration	8.7	10.7	9.0	13.4
Protection	15.0	14.7	14.3	20.9
Transportation	21.6	22.8	17.4	26.4
Health	2.9	1.4	4.6	3.7
Social services	14.6	2.2	25.1	1.2
Education	0.0	0.8	0.0	0.5
Resource conservation	2.4	1.9	1.4	1.6
Environment	14.2	14.9	12.7	12.5
Recreation and culture	11.2	12.0	8.9	9.7
Housing	2.3	1.4	1.7	1.2
Regional planning	1.9	2.2	1.1	1.4
Debt charges	4.1	13.5	3.2	7.2
Other	1.2	1.8	0.6	0.3
Total	100.0	100.0	100.0	100.0

Source: Author's calculations from Statistics Canada's Financial Management System, 1999, mimeographed. The 1988 data are actual, the 1998 data are estimates.

to more than 56 percent. The corresponding increase for the rest of Canada went from almost 54 percent to almost 57 percent. Offsetting this rise was a decline in the relative importance of provincial grants.

Property taxes in Ontario have been higher than in any other province, primarily because they are used to fund a wider range of public services. And property taxes in total grew by about 59 percent in current dollars for both Ontario and the rest of Canada over the period. When this increase is separated into its three components (Table 5), we can see that the municipal portion grew by 85 percent in Ontario and less than 40 percent in the rest of Canada. Comparing this increase with the increase in municipal spending (Table 3), one notes the extent to which municipalities, especially those in Ontario, have become more reliant on property tax funding. But the heavy use of this tax everywhere reflects its provincial role in funding schools.[4]

4 It is worth noting that local governments in the vast majority of the member countries of the Organisation for Economic Co-operation and Development (OECD) use property taxes either not at all or very little. Rather, local governments in those countries rely fairly heavily on income and sales tax revenues. (See OECD 1999.)

Table 4: ***Municipal Revenue Sources and Their Distribution, 1988 and 1998***

	1988		1998	
	Ontario	Average for Rest of Canada	Ontario	Average for Rest of Canada
	(percentage of whole)			
Property taxes	41.7	53.9	56.4	56.9
Other taxes[a]	1.3	1.5	1.1	1.3
User fees	20.0	20.0	19.5	21.7
Investment income	5.1	6.7	3.7	5.9
Other own-source revenue[b]	0.7	1.4	0.6	1.5
Total own-source revenue	68.8	83.4	81.4	87.3
Unconditional grants	7.3	4.6	3.6	2.4
Conditional grants	23.8	12.0	15.0	10.3
Total grants	31.1	16.6	18.6	12.7
Total revenue	100.0	100.0	100.0	100.0

[a] Other taxes include licenses, permits, and miscellaneous taxes such as the extra 2 percent sales tax on hotel rooms in British Columbia, the surcharge on the Saskatchewan Power Corporation in Saskatchewan, and sales tax revenues from electricity and gas sales in Manitoba.

[b] Other revenues include amusement taxes, fines, and penalties.

Source: Author's calculations from Statistics Canada's Financial Management System, 1999, mimeographed. The 1988 data are actual, the 1998 data are estimates.

The Benefits Model

These recent trends have raised a number of funding issues, some old and some new. To focus the discussion here on municipal finance issues, however, we must turn to an analytical context. Given that municipalities are creatures of the province and are the agents in the principal-agent framework of provincial-municipal fiscal arrangements in Canada,[5] I find the benefits-based model of government finance ideal for conducting this evaluation because it permits one to concentrate on decisionmaking and funding responsibilities, as distinct from production and delivery issues (see Osborne and Gaebler 1992).

The underlying principle of the benefits model is simple: those who benefit from municipally funded services pay for them. Economic efficiency is achieved when the user fee, price, or tax per unit of output equals the extra cost of the last unit consumed (which is the well-known principle of price equals marginal cost pricing). Charges applied in this fashion are efficient for funding services where the beneficiaries can be clearly identified and the costs correctly derived. Prices or taxes ration output to those who are willing to pay and signal suppliers (local governments or their delivery agents) the quantity and quality of output desired.

Setting a correct price or tax per unit is thus essential if efficiency is to be achieved. It is also critical that costs be calculated correctly and incorporated into the price. Enhanced accountability results from a close link between the quantity consumed and the price or tax paid per unit of consumption.

5 For a discussion of the principal-agent model, see Bird and Chen (1998). In this model, the province is the principal and may alter jurisdictional boundaries, local government revenue and expenditure responsibilities, and intergovernmental fiscal arrangements in its attempt to overcome differing objectives between the principal and the agent-municipality.

Table 5: ***Per Capita Property Taxes, 1988 and 1998***

Per Capita Property Taxes	1988		1998	
	Ontario	Average for Rest of Canada	Ontario	Average for Rest of Canada
		(current dollars)		
For municipal services	496	487	915	678
For provincial services	1	66	149	300
For school purposes	496	130	511	112
Total	993	683	1,575	1,090
		(constant 1998 dollars)		
For municipal services	584	624	915	678
For provincial services	1	85	149	300
For school purposes	584	167	511	112
Total	1,169	876	1,575	1,090
		(current dollars)		
Percentage growth, 1988–98				
Municipal services	—	—	84.5	39.2
Provincial services	—	—	large	large
School purposes	—	—	3.0	–13.8
Total	—	—	58.6	59.5
		(constant 1998 dollars)		
Municipal services	—	—	56.7	8.7
Provincial services	—	—	large	large
School purposes	—	—	–12.5	–32.9
Total	—	—	34.7	24.4

Source: Author's calculations from Statistics Canada's Financial Management System, 1999, mimeographed. The 1988 data are actual, the 1998 data are estimates.

The benefits model achieves fairness because those who consume public services pay for them (just as someone who benefits from purchasing milk or a movie ticket pays for it). Policymakers can address concerns about the tax burden on lower-income individuals by using income transfers from provincial or federal governments and social assistance programs targeted to individuals in need. Handling income-distribution issues through transfers or targeting[6] is far more equitable and efficient than tampering with charges or taxes.

The benefits model is most easily approximated where services do not generate spillovers or externalities, where the services are not income redistributional in nature,[7] where individuals can be excluded from consuming the service, and where precise measurement of output and costs is possible.

6 For a discussion of these programs, see Boadway and Kitchen (1999).

7 While some elements of income redistribution are inherent in almost all public services, income-redistribution services include welfare payments, children's aid, social housing, and income transfers, to name the most obvious.

Application to the Municipal Sector

Municipalities should not have to fund programs specifically directed toward the redistribution of income among individuals.

To apply the benefits model to the municipal sector, one must first identify the services for which municipalities should be responsible. They should not have to fund programs specifically directed toward the redistribution of income among individuals (social services and social housing, for example), which are more appropriately federal and provincial responsibilities. Yet neither should municipalities be viewed as strictly service agencies, specifically charged with funding only those services where the benefitting properties are clearly and unequivocally identified and where user fees can be employed elsewhere.

Municipal governments are much more than this. They provide a range of local public services (police protection, local roads, streets, sidewalks, street lighting, and so on) whose collective benefits are enjoyed by the residents within its jurisdiction. User fees may not be appropriate for funding these services. Instead, they should be paid for from a tax or taxes on local residents with grants providing the adjustments necessary to account for externalities; that is, something other than a local tax should fund benefits that spill over into neighboring communities.[8]

Provincial grants also have a role to play in funding municipal services. Specifically, conditional grants should be used for partial or full funding of services that generate spillovers and of those in which the province has an interest (for example, to ensure uniform or minimum standards). Unconditional grants are needed to fill any fiscal gaps (mismatches in local own-source revenues and expenditure responsibilities) and to support municipalities in their attempts to provide comparable levels of service for comparable tax rates (equalization).

Tax Assignment

While municipal taxes clearly have a role, the question is, which taxes? In principle and practice, this choice should be based on efficiency, equity, administrative, and compliance arguments.

On efficiency grounds, an ideal local tax is one whose tax base is highly immobile, thereby minimizing distortions in economic behavior. On equity grounds, the benefits model tells us that local taxes should capture the collective benefits of community public services. On administrative and compliance grounds, a tax on a base that is confined to the municipality is preferable (Boadway and Kitchen 1999, ch. 9).

These criteria provide a strong defense for using property taxes (see Bossons, Kitchen, and Slack 1993; Tassonyi 1993; Hobson 1997, 117–118). First, the tax base is largely immobile. Second, the property tax is effective in funding, partially at least, those services whose collective benefits accrue to the local community; hence, it satisfies the benefits-received criterion. Third, it has a long history, and relatively recent administrative improvements have increased the ease with which it can be administered.

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8 Under this view, user fees or charges are retained for funding those services whose costs and benefits can be assigned to specific properties or individuals (water and sewers, and a portion of transit and recreation, for example). For an excellent discussion of the benefit model of local finance, see Bird (1993).

Finally, given that no single tax or two taxes can be entirely fair and distortion free, a provincial or national tax system that employs a mix of taxes has considerable merit. Included in this mix is a local property tax (see Brooks 1993), but it could also include other local taxes (although they would require the approval of the relevant provinces).

Issues

Given the recent change in the provincial-municipal fiscal environment and the premise that municipalities should be responsible for funding services that benefit local taxpayers, solid economic arguments exist for implementing a number of overdue reforms in property taxes, user fees, and access to new municipal tax sources.

Solid economic arguments exist for implementing a number of overdue reforms in property taxes, user fees, and access to new municipal tax sources.

Property Taxation

In the face of increasing criticism and concern, the durability of the property tax is supported by the fact that it has been the major source of tax revenue for municipal governments for many years. Despite numerous attempts (and some success) at reforming the tax across municipalities within and across provinces, problems continue to exist, and further reforms could achieve greater fairness, efficiency, and accountability in its application. Suggested reforms extend from recommendations that all funding for income-redistribution services be removed from the local property tax base to specific recommendations for changing the tax base and rate structure. The latter two areas are the focus of this section.

What Are the Current Tax Base and Rate Structure?

The base of the property tax is the assessed value of real property. In every province, "assessed value" is some percentage of market value — sometimes as high as 100 percent but frequently a smaller proportion because of time lags and information delays in completing reassessment cycles. While few analysts disagree with the principle that all properties should be assessed in a uniform manner (specifically, at the same percentage of market value), actual assessment practices reveal a different pattern. Differences in assessment ratios are widespread and may be grouped in two categories: nonlegislated (unintentional) and legislated (intentional).

Nonlegislated differentials arise when the sales of certain properties are infrequent. In such cases, the authorities have difficulty establishing accurate market values and thus assess similar properties at different values. Although such problems still exist, recent initiatives in most provinces to move to market value assessment and more frequent reassessments have reduced many of the inequities within each property class. Inequities in assessment ratios, however, are still prevalent *across* property categories. Residential dwellings of one and two units are almost always underassessed relative to multi-unit dwellings. Older homes tend to be underassessed relative to newer homes. Commercial properties are more highly assessed than all residential properties except multi-unit dwellings but are underassessed relative to industrial and manufacturing properties.

Provincially legislated assessment differences also exist through the differential treatment of specific categories of property. For example, farmland and forest lands

receive favorable treatment; mines and mineral resources are generally, but not always, exempt from local property taxes; public utilities usually pay a tax based on gross receipts rather than assessed property values; and railway tracks are assessed under special rules (for more detail, see Kitchen 1992, ch. 2).

Because of differences in assessment practices, the application of a constant tax rate produces differences in the effective property tax rate (the ratio of tax liability to market value) within and across all properties within a community.[9] Obviously, the effective rate is higher on properties assessed at higher percentages of market value. These differentials are generally a result of assessment practices and have existed for some time. No one defends them as reflecting differences in the costs of servicing various property types. Rather, they reflect the ease with which the market is willing to bear higher taxes. Owner-occupiers tend to be more vocal in protesting property taxes than renters, who may be unaware of their tax liability, or than commercial and industrial property owners, who may try to pass the amount on to consumers or employees.

Is the Current Structure Efficient?

Failure to correlate benefits from municipal services with their cost (or an approximation of it) leads to redistribution of income that is not neutral.

If this differential tax treatment of properties does not reflect differences in the production, environmental, and social costs of providing municipal services to them, it creates a number of distortions and inefficiencies. Failure to correlate benefits from municipal services with their cost (or an approximation of it) leads to redistribution of income that is not neutral. Where effective tax rates generate tax revenue that exceeds the extra cost of delivering services, people and businesses have incentives to relocate to lower-taxed areas. To avoid difficulties of this sort and to set the base for an efficient and fair property tax system, policymakers should use variable tax rates to capture cost differences across properties, property types, and municipalities (or neighborhoods within a municipality).[10] As well or alternatively, some municipalities handle this variation through the use of special assessments or benefitting-area charges on properties in receipt of more costly municipal services.

Every province has created further distortions through deliberate efforts (authorized by provincial statutes, in many cases) to impose higher taxes through assessment differentials or differentially high tax rates on commercial and industrial (nonresidential) properties, a practice that creates efficiency and equity concerns (see Auld, Hobson, and Kitchen 1990). To illustrate, Kitchen and Slack (1993) review property taxes and municipal expenditures in eight Ontario municipalities in 1990 and conclude that nonresidential property taxes ranged from 28 to 51 percent of total local property taxes but accounted for only 31 to 40 percent of municipal expenditures. This imbalance prompts the authors to observe that the residential sector is the recipient of proportionately more benefits from local government services (welfare, elementary and

9 Notice that this comment refers to properties within a single municipality. Comparing effective tax rates across municipalities must be treated with considerable caution for differences are bound to arise when certain municipalities fund some services from user fees while others fund the same services from property taxes. Where this situation exists, differences in effective tax rates are inevitable.

10 As has been done in British Columbia for some time and was introduced to Ontario in 1998. Variable tax rates can assist in achieving a specific land use pattern; for example, higher tax rates on suburban *vis-à-vis* downtown properties may result, at the margin, in a higher concentration of activity in the downtown core. For an evaluation of the implications of variable tax rates, see Slack (1991).

secondary education, libraries, recreational facilities, and so on) than the nonresidential sector. Combining the disproportionate benefits and high effective property tax rates, the study concludes that the nonresidential sector is overtaxed and the residential sector undertaxed.

A more recent study for the city of Vancouver (KMPG 1995) on relative consumption patterns suggests that residential properties paid 40 percent of property taxes and consumed 71 percent of the services while nonresidential properties paid 60 percent of all property taxes and consumed only 29 percent of municipal services. Because of these findings, Vancouver city council has shifted some of the tax burden to the residential class from the nonresidential class.

The subsidization of municipal services for the residential sector by the commercial and industrial sector generates at least two potentially serious efficiency concerns. First, given that the needs and demands of the residential sector (voters) drive the level and quality of municipal services and that this sector pays a tax that is less than its marginal social cost, there is every reason to believe that an oversupply of municipal services ensues.

Second, as long as the property tax on the nonresidential sector exceeds the benefits received and is unrelated to the profitability of a firm, it effectively represents a fixed cost of doing business — a cost that is neither related to public services used by the sector nor likely to be passed on without distorting economic behavior. Where a profit-insensitive tax leads to overtaxation of businesses, it may lead to a reduction in economic activity, lower output, fewer jobs, and a less competitive business environment (Canada 1997). This point is particularly important because of Canada's heavy reliance on exports and resources and its exposure to world markets.

If allocative efficiency became a stronger objective of municipal governments and if the property tax were applied according to benefits received, the current discrimination against nonresidential property should be removed.

In summary, if allocative efficiency became a stronger objective of municipal governments and if the tax were applied according to benefits received, the current discrimination against nonresidential property should be removed. One cannot, however, ignore the difficulty in accomplishing this shift without the provision of transitional funding and the explicit political will to shift taxes among classes.

Who Pays the Tax?

Who actually pays the property tax? The answer to this question depends on whether one is examining residential or nonresidential properties.

Residential: The strongest and longest-standing criticism of the residential property tax is that it is unfair because it absorbs a higher percentage of the income of low-income earners than of high-income earners. Although municipal officials and taxpayers raise the issue of unfairness frequently, it is misleading.[11] First, the property tax is not a tax on income; it is a tax on the assessed value of property. If assessed property values are not directly and closely correlated with income, the tax is bound to absorb a higher percentage of a low income. (Indeed, this issue is exactly the same as the issue of the fairness of any other tax applied on the base of something other than income but judged as a percentage of income.)

11 For a more detailed discussion, see Boadway and Kitchen (1999, ch. 7).

Second, since the appropriate role for the property tax is as a funding source for services that provide collective benefits to the local residential community, its fairness is surely increased if it is applied on a consistent basis across all residential properties. This coherence is best achieved through uniform assessment and the application of variable rates to capture the different costs of municipal services consumed by residents of different property types and location.

Third, to remove some of the tax's alleged unfairness on individuals and families, provinces and municipalities currently make relief available through property tax credits, tax deferrals, exemptions, grants, reductions, cancellations, or refunds. One must, however, question the wisdom of property tax relief schemes provided in isolation from other government tax relief. Arguments in favor of property tax relief are no more relevant than those in favor of relief for every other type of tax. Greater fairness in the tax system could surely be achieved through the introduction of a tax-relief scheme based on ability to pay and implemented by the province or the federal government, rather than through a number of separate and disparate schemes, some of which are the responsibility of the federal or provincial governments while others are the responsibility of municipal governments.

The overtaxation of nonresidential property is often defended on the grounds that the owners of such property owners are better able to pay property taxes than the owners of residential property.

Nonresidential: The overtaxation of nonresidential property[12] is often defended on the grounds that the owners of such property are better able to pay property taxes than the owners of residential property. Underlying this claim is the assumption that nonresidential property owners bear the burden of the tax and do not shift it to others. Is this what happens? While the answer may differ by property type (banks versus corner convenience stores versus large manufacturing establishments and so on), the general conclusion is that the tax is borne by one or more of the following: consumers inside and outside the taxing jurisdiction, landowners, capital owners, and labor.

Of these groups, which is most likely to bear the tax? It depends on market conditions and factor mobility.[13] With the growth in international trade in goods and services over the past few years, Canadian businesses are driven more and more by international events. In other words, international factors play a major role in attempts to shift the tax. For example, if commodity prices are set on world markets, it is not possible (other things being equal) to shift the tax forward; rather, it is borne by owners or employees. Where capital is immobile and labor mobile, the tax differential is borne by the owners. Where capital is mobile (the most common case), the tax is likely to be borne through wages and salaries that are lower than they would have been in the absence of the tax. Under other mobility assumptions, the tax may be shared between owners and employees.

Although the outcome in specific cases is unclear and depends on a number of factors, it is quite likely that the burden of overtaxation generates income distributional consequences that are unfair on grounds of either ability to pay or benefits received.

In summary, differentials in property taxes that are not offset by differentials in public services or other market factors are expected to affect commodity prices and

12 This discussion does not refer to the portion of the property tax that covers the cost of municipal services used by the nonresidential sector. That portion is a cost of doing business, like the cost of labor or materials used in producing goods and services.

13 For a lengthier discussion, see Kitchen and Slack (1993).

returns to owners and employees. The degree to which each of these shares in the burden will depend on the elasticities of demand and supply and the mobility of labor and capital. Although there are no firm conclusions about who bears the burden of the nonresidential property tax, one clearly cannot argue on ability-to-pay or benefits-received grounds that the current overtaxation of this sector relative to residential property is fair or equitable.

Are Property Tax Differentials Capitalized in Market Values?

Property tax *capitalization* refers to the effect of local government taxes and expenditures on properties' market values. Consider the case of two cities that are identical in every respect (structure, demography, and provision of local public services) except that property taxes are higher in one than in the other. If residents are aware of this differential, it becomes capitalized into property values that are lower in the higher-taxed city than in the lower-taxed one. As long as the differentials are capitalized into property values, the tax provides no incentive to live in one community over another, and in that sense it is efficient.

If the property tax were a true benefits tax designed to fund local government services, the tax price would equal the marginal benefits from the services received and there would be no incentive to move from one community to another in order to minimize the net tax burden (expenditures minus taxes). Indeed, under this scenario, individuals who desired more public services might move to communities with *higher* property taxes. Since the property tax is not a true benefit tax, however, distortions may exist, and citizens may choose to relocate to improve their net gain.

Under the current system of differential assessment practices, distortions arise if the differential in property taxes for funding similar services is not capitalized into property values. Although the jury is still out on the extent to which capitalization arises under assessment differentials of the type that exist in Canada,[14] one study (Chinloy 1978) based on data from London, Ontario, finds no evidence of their capitalization into property values. If differentials are not capitalized, then some properties are overtaxed while similar properties are undertaxed and the case for improving the property tax system becomes more compelling.

User Fees

If correctly set, user fees have all the efficiency advantages of private sector prices.

User fees are imposed for a variety of municipal services, from water to public transit to the use of parks and recreational programs and garbage collection. If correctly set, these fees have all the efficiency advantages of private sector prices. They ration output to those who are willing to pay, and they signal local governments about the quantity and quality of output desired. In reality, however, government seldom sets prices or user fees correctly. Instead, they are generally designed to raise revenue, rather than to serve as a rationing and demand-signaling device.

Failure to price properly has created a good deal of unplanned and implicit redistribution, much of which would be unacceptable if it were made explicit (Bird

14 For a summary of the theoretical and empirical literature on capitalization of property taxes, see Mieszkowski and Zodrow (1989).

1976, 104). For example, the tendency to charge a fixed price for water, regardless of quantity consumed, on the premise that the poor and seniors on fixed incomes cannot afford to pay more, provides an implicit subsidy for higher-income households with larger lawns to water and more cars to wash.

In principle, municipalities may achieve efficiency, fairness, and accountability in the provision of a specific service if the price or charge per unit equals the extra cost of the last unit of output consumed.

In principle, municipalities may achieve efficiency, fairness, and accountability in the provision of a specific service if the price or charge per unit equals the extra cost of the last unit of output consumed. In practice, however, some services for which user fees may be applicable encounter problems when it comes to the adoption of this pricing principle. These difficulties, which are not insurmountable, include estimating marginal cost and determining the correct user charge when economies of scale are present, when capacity constraints exist, when demand differs in peak and nonpeak periods, when second-best considerations are prevalent, and when externalities exist. (For more detail, see Boadway and Kitchen 1999, ch. 7; Bird 1976; Bird and Tsiopoulos 1997; Tassonyi 1997, 185–193.)

Water Supply and Sewage Treatment

Water provision in Canadian municipalities is characterized by five basic rate structures: a flat rate charge, a charge based on property assessment, and three kinds of volume-based charges (Tate and Lacelle 1995). A flat rate water charge is the most commonly used structure for residential properties, and a number of municipalities also use it for commercial properties. Flat rate charges are unrelated to water consumption. Their structure is typically very simple, although some systems have become fairly complex. The rate often varies by type of customer (residential versus commercial). In addition, it may vary by the property's characteristics (for example, number and type of rooms, number of water-using fixtures, number of residents, size of lot, presence of a swimming pool, size of service connection, and so on).

Some indirect methods of charging for water are equivalent to a flat rate. Based on property assessment, they come in the form of an addition to the property tax bill, frontage charges, or special assessments. They are, however, used in few municipalities.

Volumetric (volume-based) charges require the use of meters and take one of three forms: a constant unit rate, a declining block rate, or an increasing block rate. A constant unit rate, the most common type of volumetric charge used in Canada, is an identical charge per unit of consumption (cubic meter, for example) and seldom differentiates among customer classes. It is the most common type of volumetric charge used in Canada. A declining block rate structure generally includes a basic or fixed service charge per period combined with a volumetric charge that decreases in blocks (discrete steps) as the volume consumed increases. Typically, one or two initial blocks cover residential and light commercial water use, with subsequent blocks levied on heavy commercial and industrial uses. The fixed component of the charge often varies with the size of the service connection. Minimum charges corresponding to a minimum amount of water consumption in each billing period are common in these systems. Environmentalists generally do not prefer declining block rates because they do not capture the social costs associated with water consumption. An increasing block rate structure, which is used in very few municipalities, is like the decreasing block rate structure except that the volumetric charge increases in steps as consumption increases and there is no minimum charge.

Sewage collection and treatment expenses are almost always recovered through surcharges on water bills. For residential and most commercial and industrial customers, the charge is not based on sewage flow. The most common type is a flat rate charge, which is used not only in municipalities with flat rate water charges, but also sometimes in those with metered water rates. For other municipalities, the sewer charge is a percentage of the water bill.

Since achieving efficiency requires setting the price to cover the marginal cost, municipalities must use water meters. Yet, as of 1996, less than 45 percent of all Canadian municipalities were metered for residential water and almost 60 percent for commercial and industrial water.[15] In addition, prices are generally based on average costs, peak load demand is not taken into consideration, and distance from source of supply is not captured. Not only does this lead to an inefficient allocation of resources, it is unfair on the basis of benefits received, since customers whose price exceeds marginal cost subsidize those whose price is below.

A recent study based on 77 water utilities in Ontario (Renzetti 1999) concludes that the marginal cost of water supply and sewage treatment exceeded the price for water output and sewage treatment in every municipality studied. The average price of water for residential customers was $0.32 per cubic meter and the estimated marginal cost was $0.87. For the nonresidential sector, the average price was $0.734 per cubic meter and the estimated marginal cost was $1.492. At the same time, the average price of sewage treatment was $0.128 per cubic meter while the average marginal cost was $0.521. In Renzetti's comparison of small and large utilities, the discrepancy between price and marginal cost was higher for the small utilities. For instance, the five smallest municipalities in the sample reported average price and marginal costs for residential water of $0.12 and $1.15 per cubic meter, respectively. Conversely, the five largest municipalities in the sample reported average price and marginal costs of $0.21 and $0.45 per cubic meter. When the sample was separated into municipalities with and without meters, the discrepancy between price and marginal cost was greater for the nonmetered.

Underpricing water and sewage means there is no incentive to restrict consumption or to consume in an efficient manner.

These large deviations between marginal cost and price generate estimates of noticeable deadweight loss per unit of output. Underpricing water and sewage generates a higher level of consumption than is allocatively efficient (there is no incentive to restrict consumption or to consume in an efficient manner). As well, it has led to investments in water and sewage treatment facilities that are larger than would exist under a more efficient pricing policy (Renzetti 1999). And Gardner (1997) and Postel (1993) suggest that underpricing water supply and sewage treatment has discouraged innovation in developing alternative water and sewage treatment technologies.

Public Transit

Municipal transit systems everywhere are financed from fare box revenues, other local revenues (primarily property taxes), and provincial grants. In most communities, the tendency is to set different fares for adults, children, students, and seniors and to offer

15 Unpublished data provided by the federal Department of the Environment.

discounts for monthly passes. Fare revenues, however, generally finance only 50 to 75 percent of all operating costs (Canadian Urban Transit Association).

Concern over the size of operating deficits that are subsidized from other revenue sources generates frequent discussion over the level and structure of fares that transit users ought to face. Needless to say, local fare setters consider a number of social, economic, and political factors, including the availability of and access to substitute forms of transportation, the ability of residents to pay for transit services, the attitudes of politicians toward acceptable levels of fares, and the portion of operating costs to be recovered from fare box revenue (Kitchen 1990).

Asking public transit users to pay a price equal to the full marginal social cost would be efficient and fair only if private transit (automobile) users paid a charge that reflected their full marginal social cost. Since the latter does not happen, marginal cost pricing for public transit is inefficient, and efficiency must be achieved here by subsidizing local public transit.[16] The question then becomes one of establishing the correct subsidy (Bird 1976, 64–68).

The current fare structure does, however, create economic problems through what it does and does not do. Failure to charge higher prices in peak hours has led to over-investment and greater capacity than can be justified on efficiency grounds. On the other hand, higher peak-load fares may discourage public transit use and increase the use of private autos. To prevent excessive auto use, a more effective and direct policy might involve higher charges in the form of automobile licenses, municipal parking fees, or effective regulations restricting use.

To prevent excessive auto use, a more effective and direct policy might involve higher charges in the form of automobile licenses, municipal parking fees, or effective regulations restricting use.

Problems generated by the lack of peak-load charges are complicated by the availability of quantity discounts. These discounts are used primarily by rush-hour travelers, effectively lowering the per trip charge precisely at a time when higher fares would make more economic sense. As well, lower fares for senior citizens, children, and students are difficult to justify, especially at peak hours when transit systems are overused. And any subsidies that are supplied on the basis of age and completely unrelated to income are difficult to support on efficiency grounds.

Finally, since the marginal cost of carrying a rider varies with distance traveled, failure to use zone charges within large municipalities creates efficiency and fairness problems. Fixed fares mean that short-distance travelers overpay while long-distance travelers underpay. This kind of subsidization policy is subject to the same criticism I directed above at reduced fares for seniors, children, and students.

Public Recreation

Municipal parks and recreational facilities that charge user fees include ice arenas (for skating admission, hourly ice rentals, and instruction), swimming pools (for admission, membership, and instruction), tennis courts (for court fees, membership, and instruction), camps and camping sites (for campground fees and day camp charges), golf courses (for greens fees, membership, and instruction), and so on. User fees for funding these services have increased over the past few years, but one survey of 19 municipalities in southern Ontario notes two common features: the exclusion of capital costs in

16 This is, of course, a second-best argument.

establishing the fees, and the relatively small proportion of operating costs covered (Sproule-Jones and White 1990, 1483).

These pricing practices are generally defended on two grounds. First, they permit individuals to use recreational facilities comparable to those they cannot afford in the private sector. This type of subsidization is neither efficient nor fair because municipalities ought not to be concerned with major questions of income distribution. Furthermore, if redistribution was a local responsibility, it should be provided through relief based on income or some other measure of ability to pay, not by reducing prices for everyone.

Second, municipal recreational facilities and programs generate positive externalities. They may take the form, it is suggested, of a more physically fit and healthier society and hence lower medical costs for everyone. In reality, this supposition is questionable since the externalities are unlikely to be significant. (Indeed, they would probably be greater under an alternative and equally subsidized scheme of improved health and educational programs.)

Because the largest portion of the benefits of recreational facilities accrue directly to users, these services should be priced so as to extract sufficient revenues to cover a comparable portion of the costs.

Because the largest portion of the benefits of recreational facilities accrue directly to users, these services should be priced so as to extract sufficient revenues to cover a comparable portion of the costs. The public sector has not, however, adopted many aspects of private pricing for similar services. Private suppliers, faced with the prospect of recovering all costs through their pricing structures, recognize the advantages of such things as an annual fixed levy plus an admission charge for each use of the facility. Municipalities virtually never follow this approach and thus neither cover the cost of nor efficiently utilize their scarce resources.

Queuing, rather than price, generally rations access to municipal facilities (except for a few services, such as arena rentals and golf courses). The failure to adopt a peak-load pricing policy, so as to even out the demand over days and weeks, has led to overinvestment in many local facilities. Reduced rates for children and students at all times aggravate this situation (Bird and Slack 1993, 70–73). One might justify lower fares for specific groups by limiting them to use of the facility in off-peak hours (as private facilities often do). Such a policy would approximate the use of a peak-load pricing structure.

Library Charges

The current structure of the user fees that most local public libraries employ may need reorganization. They collect money from rentals, overdue books, and nonresident fees (a fixed charge) but never from local residents on a usage basis. Consequently, a high percentage of funding for local public libraries comes from general municipal revenues.

This subsidy makes sense only if significant and positive externalities arise from the existence of public libraries. Clearly, positive externalities do exist, both because libraries provide easy access to a vast collection of resources and because a more educated society creates a better environment in which to live. Substantial private benefits, however, also accrue directly to the users of library services. Thus, it is difficult to justify the degree of general funding currently provided. A better policy would be one consisting of a usage charge approximating the marginal private cost of each visit plus a provincial government subsidy covering the spillover benefits that extend beyond the local community.

Solid Waste Collection and Disposal

A recent survey of municipalities across Canada (McDavid and Eder 1997) notes that 75 percent of respondents (327 completed the survey) used property taxes alone for funding solid waste collection; a further 22 percent reported charging households directly. Overall, 29 municipalities (2.4 percent of respondents) reported using prepaid tags — a user fee — as a way of funding all or part of residential garbage collection costs, but only three municipalities applied this system exclusively. The other 26 used it to charge for extra cans or bags above a specified limit.

Recent concerns over raising property taxes to fund local services and difficulties in locating disposal sites have encouraged municipal officials to take a serious look at user fees for waste collection and disposal.

Recent concerns over raising property taxes to fund local services and difficulties in locating disposal sites have been instrumental in encouraging municipal officials to take a serious look at the possibility of user fees, generally in the form of a specific charge per bag or container, for waste collection and disposal. The arguments for imposing a per bag charge are persuasive. As with water, users of the services can be identified and per unit costs calculated. A charge that included the full marginal social costs of collection and disposal[17] would lead to more efficient use of local resources and provide incentives for individuals to minimize the amount of garbage they produce (Ontario Fair Tax Commission 1993, 583–594).

Unlike water, however, garbage has spillover consequences; for instance, individuals may avoid the tax by throwing their refuse on neighboring properties or disposing of it in rural areas. The higher the price for collection service, the greater the incentive for generating these undesirable spillovers. This tradeoff between an acceptable price and reducing spillovers is at the root of the current experimentation with user fees for garbage collection. The concern about spillovers suggests that prices will always be less than the socially efficient ideal, but one must applaud the practice of imposing a user fee of some sort. It will certainly lead to greater concern about generating garbage and increase attempts to improve efficiency in providing local service.

Police Services

Municipal police services, which include numerous functions, are financed almost entirely from general local revenues. The only services for which special charges are levied are those that involve the policing of special events.

One can make a case for general funding as long as police services generate positive externalities, but to the extent that they have private-use characteristics, efficiency and equity suggest greater emphasis on charges imposed on direct users. Evidence of the privateness of some police services does exist. For instance, firms often buy protection from private agencies, and individuals may purchase security systems and guard dogs. Since these activities are priced in the private sector, they could also be priced in the public sector. Indeed, such charges might generate the revenue needed for a closer-to-optimal level of police services than currently exists.

For police services with private-good characteristics, difficulties in establishing a price that equals marginal social cost are likely to negate its implementation. One can argue, however, that all individuals in a group that benefits from a certain service

17 For a detailed discussion of proper pricing for solid waste disposal (landfill sites), see McRae (1994).

ought to pay a price that is the same for all members of that group. For example, special vehicle or operator license fees levied at the local level or transfers to local governments of provincially collected revenue from road-user taxes (on gasoline, for example) and fines for traffic offences (as recently implemented in Ontario) could help to cover part of the police costs associated with traffic control and safety.

In addition, municipal authorities could impose fines on people who do not lock automobiles or residential, commercial, or industrial buildings because this failure encourages criminal behavior and increases police protection costs. In fact, some commentators suggest levying special fees or charges on all enterprises with a high incidence of crime while providing reduced rates for those dwellings where the incidence of criminal behavior is substantially lower.[18]

Fire Services

Fire protection is a municipal responsibility that is financed from local revenues. As well, some municipalities charge neighboring jurisdictions for fire protection, and many charge individuals or insurance companies for assisting with road vehicle accidents.

The issue here is whether general property tax funding for fire protection is fair and efficient. While the presence of positive externalities supports such funding, the externalities tend to be reciprocal; hence, one can defend charging every taxpayer full direct costs. In this system, general revenue funding would be unnecessary; instead, everyone would be required to buy fire protection (Bird 1976, 137).

Prices for fire protection, as distinct from police protection, already exist through fire insurance policies. Premiums for a property reflect its distance from fire halls and its fire insurance experience as well as the risks associated with various structural types, the use of fire-resistant building materials, and the presence of sprinkler systems.

Factors that affect insurance risks also determine municipal expenditures for fire service. Failure to differentiate on the basis of risk the prices charged for protection almost certainly leads to an oversupply of fire-fighting equipment. For example, failure to impose differential prices provides little incentive for the owners of risky properties to undertake actions designed to minimize their need for fire protection and hence generates a demand for more expenditures on fire protection than would otherwise be the case.

Municipalities should have access to other tax revenues for funding services (such as social housing and social services) that are income redistributional.

Additional Tax Sources

Does a case exist for giving municipalities additional tax sources? Although property taxes and user fees play an important role in funding local government services that benefit local residents individually or collectively, they are more difficult to defend for supporting services that are income redistributional (such as social housing and social services) or that benefit, even partially, residents of other communities (visitors and commuters). Thus, one can argue that municipalities should have access to other tax revenues for funding these types of services. In particular, income distributional services could be funded from a municipal tax or surtax on personal incomes because it

18 For more detail on the rationale behind this suggestion along with a description of how it might be implemented, see Bird (1976, 129–133); and Bird and Tsiopoulos (1997).

is based on ability to pay. Similarly, services from which visitors and commuters benefit could be funded from taxes paid by nonresidents. Examples include a personal income tax deducted at the source of employment, a municipal sales tax, a local hotel and motel occupancy tax, and a municipal fuel tax. Each of these is discussed below.

Municipal Income Taxation

Although Canada's municipalities are permitted no direct access to income taxes,[19] some form of local income tax exists in approximately half of the countries that are members of the Organisation for Economic Co-operation and Development (OECD 1999). In some of these jurisdictions, the central government administers and collects the tax and transfers the funds to municipalities. In others, municipalities have some type of independent control — sometimes over the rate but not the base, in other cases over both the rate and base.

As with other potential tax options, two alternatives exist for administration. First, municipalities could choose to piggyback onto the existing provincial income tax by adding additional percentage points to it. They would have to accept the definition of taxable income and the allowable credits used in the federal and provincial systems.

Alternatively, a municipality might administer its own income tax system. While this alternative would have the potential for generating more local autonomy and flexibility, it would be more expensive to administer. Under a separate municipal income tax system, local authorities would determine the tax base. For example, if the tax was levied only on earned income, it could be deducted at the source, like a payroll tax. A levy on unearned income (interest, dividends, rent, and so on) as well would require more sophisticated administrative machinery. Decisions would also have to be made on whether or not commuters should be taxed and, if so, whether they should be treated differently from residents.

The use of a municipal income tax to fund income redistribution is plausible, and it is also defensible as a base for funding services that provide benefits for local residents and visitors alike, especially commuters. Under the current system of funding these services from the property tax, commuters do not contribute directly; their situation is no different from that of all other provincial residents who pay the provincial taxes that constitute funding for grants that are allocated to municipalities. Thus, a rationale for a local income tax deducted at source (place of employment) is that it would allow the municipality to tax commuters for benefits they receive from local public services (roads and streets, parks and libraries, sidewalks and streetlights, police and fire protection, and so on).

A local income tax deducted at source would allow the municipality to tax commuters for benefits they receive from local public services

Municipal Sales Tax

A number of US and European cities levy a municipal sales tax, but Canadian municipalities cannot do so. Like the local income tax, it could be administered through

19 Some people think an exception exists in that municipalities in Manitoba receive annually from the province per capita unconditional grants partially based on the amount of revenue generated from 2 percentage points of the provincial personal income tax and 1 percentage point of the provincial corporate income tax. This funding is not a local income tax, however, because local officials have no say over the tax rate or base.

piggybacking onto the existing federal or provincial sales tax structure. Alternatively, each municipality might operate its own tax independently. Piggybacking through adding 1 or 2 percentage points would be less costly to administer, but that advantage would come at the expense of less flexibility and local autonomy, features usually characteristic of a locally designed and administered tax.

The rationale for a municipal sales tax as a supplement to the local property tax is similar to that for a local income tax. As long as municipal services are funded from property taxes imposed on local residents, nonresidents who benefit from these services avoid direct tax contributions. The imposition of a retail sales tax would allow the local jurisdiction to use the tax system directly in order to recover some of the extra costs of providing local services (roads, streets, public transit, police protection, and so on) that are required in order to accommodate nonresidents (visitors and commuters).

A retail sales tax would allow the local jurisdiction to use the tax system directly in order to recover some of the extra costs of providing local services required to accommodate visitors and commuters.

Hotel and Motel Occupancy Taxes

In Canada, provincial and federal sales taxes are currently applied to hotel and motel accommodation. In Manitoba and British Columbia, municipalities also have the option of levying such occupancy taxes. In the former, municipalities may levy sales taxes on liquor, hotel accommodation, and restaurant meals; these taxes are subject to approval of the provincial cabinet and may be collected by the province. In the latter, a municipality may ask that the hotel room tax be levied at 10 percent rather than 8 percent, with the revenue from the additional 2 percentage points being transferred to the local government.

Wherever occupancy or room taxes are used, they are an additional levy on existing provincial and federal sales taxes. Proponents defend such a tax on the grounds that it compensates local governments for the expanded services provided tourists or visitors (for example, the additional police and fire protection, as well as the highway and public transit capacity needed to meet weekend or peak convention and tourist demands). The simplest and least costly way of administering this tax is to piggyback it onto existing provincial or federal sales taxes.

Municipal Fuel Tax

Many US cities levy fuel taxes, but they are scarce at the municipal level in Canada. The Greater Vancouver Regional District levies a tax of 4 cents per liter (soon to be 6 cents) for transit and transportation services within its borders. Similarly, both Victoria and Montreal impose a tax of 1½ cents per liter, with revenues generated in each city used for transit services there. Cities in Alberta now share in provincial fuel tax revenues, although they have no say in the rate — it is determined solely by the province, which collects the revenue and transfers it to the cities.

Regardless of where municipalities have the authority to levy fuel taxes, the revenues are generally earmarked for local roads and public transit or are intended to replace provincial grants that were previously provided for local transit and roads. While municipalities might wish to administer this tax, administration costs dictate against their doing so. Instead, it makes sense to piggyback onto the existing provincial

fuel tax with the province remitting revenues on the basis of amounts collected in each municipality.

One can view this tax appropriately as a benefits-based tax, and it has considerable merit as a means of funding local roads and municipal public transit (see McCormick Rankin Corp. 1998).

Summary and Desirable Reforms

The combination of provincial downloading of funding responsibilities, decreases in the relative importance of grants, and corresponding increases in reliance on own-source revenues has changed the fiscal environment in which municipalities must operate.

The past decade's combination of provincial downloading of funding responsibilities, decreases in the relative importance of grants, and corresponding increases in reliance on own-source revenues has changed the fiscal environment in which municipalities must operate. This shift has brought to the forefront issues about the funding responsibilities of municipal governments, concerns about the role and structure of property taxes and user fees, and questions of giving municipalities access to new tax sources.

Although most municipal officials, many taxpayers, and some analysts condemn the recent provincial downloading, their criticisms are seldom couched in any solid analytical framework that answers the question, what should municipalities do and how should they fund what they do? To respond adequately, one can turn to the benefits-based model of government finance as appropriate for evaluating the role of the municipal sector. In it, taxpayers pay for public services according to benefits received. Local governments are responsible for funding services whose benefits are primarily confined to the local community, and provincial and federal governments for services that redistribute income and those in which they have a distinct interest in the standard of service provided.

User fees and local taxes also play an important role. User fees are fair, efficient, and accountable for financing those services for which administrators can identify individual beneficiaries, exclude nonusers, and estimate the per unit cost of provision.

The benefits model also fits local taxation when it is used to finance services whose collective benefits are enjoyed by the residents of the local jurisdiction but it is impossible to identify individual beneficiaries or exclude individuals or properties from the service. Here is a major role for the property tax.

Recent provincial downloading and reduced provincial funding have, however, placed considerable pressure on the property tax base, raising the importance of introducing provincial legislation that would permit municipalities to implement one or more new local taxes. One can defend such enlargement on benefits-based grounds. Of the alternatives that are generally viewed as possible supplements to — not substitutes for — property taxes, access to a municipal fuel tax would make considerable economic and political sense, especially in large urbanized areas with severe traffic congestion. Such a tax could be administered easily if piggybacked onto the provincial fuel tax, would be relatively efficient and fair, and would likely be politically acceptable if the revenues were used to fund local transit and transportation expenditures. In addition, a municipal sales tax and, more specifically, a hotel and motel occupancy tax could satisfy, at least in a crude fashion, the criteria for approximating a benefits-based approach to municipal taxation. A municipal income tax, on the other hand, would have less appeal, especially if municipalities are free from

funding major income redistribution services and services for which national standards are important.

While property taxes and user fees have been the mainstay of municipal revenues for some time and will continue to play an important and crucial role in the future, current practice in setting tax rates and user fees often deviates from what is fair, efficient, and accountable.[20] In particular, assessment practices should be improved so that all properties (commercial, industrial, and residential) are assessed in a uniform manner (at the same percentage of the assessment base). As well, differential tax rates should be used to reflect differences in the cost of servicing properties that differ in type or location. Solid analytical and empirical arguments support altering the current tax treatment of residential *vis-à-vis* commercial and industrial properties. In every province, nonresidential properties are currently taxed at higher rates than residential properties, yet the available evidence suggests that the latter receive the majority of local benefits. More closely aligning property taxes with services received could reduce the number of distortions and inequities and improve the nonresidential sector's ability to be more competitive.

User fees could also benefit from changes in their structure. Ultimately, the objective in setting fees is to establish a clear link between services received and fees paid. This goal should be relatively easy to meet for water and sewers, public transit, public recreation, libraries, and solid waste collection and disposal, where pricing structures could and should take into consideration cost differentials attributable to such things as distance from source and peak-period use. For services such as police and fire, setting user fees could be more complicated but not impossible; indeed, their use could almost certainly lead to improvements in the allocation of municipal resources. For services whose benefits are of a collective nature, such as roads and street lighting, user fees are not appropriate.

While the economic arguments for reforming property taxes, imposing user fees, and giving municipalities access to new tax sources are solid and have been around for some time, they have never received much political support. In part, the reason may be the provinces' reluctance to relinquish any control over municipalities and unwillingness to permit them access to additional tax sources currently in the provincial domain. Failure to reverse the unfavorable treatment of nonresidential versus residential properties may be a direct result of the fact that people vote, businesses do not. The highly visible nature of the residential property tax significantly deters increasing its rate (and lowering the rate on nonresidential properties). Refusal to introduce efficiency considerations into the pricing structure of many user fees or to seriously entertain suggestions for expanding their use is defended on the grounds that they are regressive. Of course, that attempt at vindication is nonsense: the prices of milk and movie tickets are also regressive.

Refusal to introduce efficiency into the pricing structure of many user fees or to expand their use is defended on the grounds that they are regressive. Of course, that attempt at vindication is nonsense: the prices of milk and movie tickets are also regressive.

Given past political resistance, why should one believe that these reforms would receive political acceptance in the future? While the answer is uncertain, the probability of securing these changes may now be greater than ever. Given the increasing role that cities and regions play in the global economy and the recent trend toward greater

20 This comment, it must be emphasized, is about current practice. It has nothing to do with whether or not these revenue sources are appropriate for local governments. It is simply an acknowledgment that improvements could and should be made in both their design and application.

reliance on own-source revenues, improving the efficiency of municipal taxes and enhancing their accountability is becoming more urgent. In particular, political resistance to raising local property taxes in general is increasing the emphasis that should be placed on correctly designing user fees, especially for water and sewers, public transit, and solid waste collection and disposal. As well, the current practice of overtaxing the nonresidential sector must be reversed if businesses are to compete in increasingly competitive international markets. Finally, municipalities should be given access to local fuel taxes and local sales taxes, both of which could be piggybacked onto existing provincial taxes with rates set locally.

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